Wages, employment and economic shocks: Evidence from Indonesia

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Abstract. After over a quarter century of sustained economic growth, Indonesia was struck by a large and unanticipated crisis at the end of the 20th Century. Real GDP declined by about 12% in 1998. Using 13 years of annual labor force data in conjunction with two waves of a household panel, the Indonesia Family Life Survey (IFLS), this paper examines the impact of the crisis on labor market outcomes.

JEL classification: J2, J3, O1

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1. Introduction

After over a quarter century of sustained economic growth, Indonesia was struck by a major economic crisis at the end of the 20th Century. The crisis, which worked its way through many of the South East Asian “tigers” was

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presaged by the collapse of the Thai baht in the middle of 1997. During the second half of the year, the Indonesian central bank attempted to stave off pressure on its currency, the rupiah. Interest rates quadrupled and the rupiah depreciated by about 60%. In January 1998, the rupiah collapsed. It lost about 75% of its value in a matter of a few days. The collapse of the rupiah was followed by spiralling prices; annual inflation is estimated to be about 80% for 1998.

The impact of the crisis in Indonesia was not confined to the financial sector. The economy went into a tailspin. Real output in 1998 was estimated to have been about 12% below its 1997 level (a bad year for some because of the drought due to El Nino) and economic growth turned positive only in 2000. The crisis was accompanied by dramatic and far-reaching political change.

By any metric, the crisis in Indonesia has been extremely severe – far more severe than in any of its South East Asian neighbors. For example, a year after the crisis began, the Thai baht and Philippine peso stood at about half their pre-crisis values; the Indonesian rupiah had fallen to about one-quarter its 1997 value. A collapse of this magnitude is not unique: the Russian rouble and Ecuadorian sucre were both reduced to one-quarter of their value over twelve months in 1998/1999. Relative to the Russian and Ecuadoran crises, the crisis in Indonesia was different in one key dimension: its timing and virulence were largely unanticipated. For example, in January 1998, the Government of Indonesia predicted that for the year economic growth would be zero and inflation would be 20%. They were not alone in painting this rosy picture. In July, 1998, the World Bank admitted, “Few predicted the Indonesian crisis, and certainly none its severity. . . . Indeed, Indonesia seemed better positioned than many other crisis countries on bellwether indicators such as growth, the fiscal stance, the external current account, foreign exchange reserves, and inflation.” (World Bank 1998.)

The basic facts of the Indonesian crisis have been widely documented at a macro level (Cameron 1999; Pangestu 1999). The underlying causes of the crisis, and appropriate macroeconomic remedies, have been the subject of considerable debate. (See, for example, Corsetti et al. 1998a, 1998b; Radelet and Sachs 1998; Krugman 1998; and IMF 1999.)

Substantially less is known about the magnitude and distribution of the micro-economic impacts on the lives of Indonesians. For example, there is controversy about even basic questions regarding the magnitude of the shock on wages and employment. Some have claimed that the crisis has brought rampant unemployment (ILO, 1999) and called for investments in public works programs (World Bank 1998). Others have suggested that employment remained remarkably stable through the crisis while real wages collapsed (Frankenberg et al. 1999; Papanek and Handoko 1999, and Feridhanuset-awan 1999).

Many key issues have received little attention. How do labor markets adjust to a large, abrupt economic decline of the magnitude experienced in Indonesia? Are urban and rural labor markets affected similarly? Do the economic effects differ among the lower, middle, and higher income segments of the labor market? Answering these questions is important not only for documenting the size of the Indonesian crisis and its distributional impact, but, also to provide insights into more general questions about the functioning of markets – particularly labor markets – in low income settings.